sharekhan special

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Q3FY2007 pharma earnings preview

Generics under exclusivity, sustained domestic growth and steady exports to maintain growth momentum

Key points

- We are positive on the Indian pharmaceutical sector and expect most companies to report good earnings growth for Q3FY2007, driven by continued domestic growth, steady contributions from exports and synergies arising out of integration of acquisitions. We expect the pharmaceutical companies under our coverage to report a revenue growth of 22.7% for Q3FY2007.
- Despite the de-stocking impact caused by the anticipatory introduction of value-added tax (VAT) in Tamil Nadu with effect from January 1, 2007, the branded formulation business in the domestic market continued its growth momentum in the quarter. The growth momentum was maintained on the back of aggressive new product launches and continued focus of companies on the high-growth chronic lifestyle segments. The companies with a wider domestic presence like Cipla, Sun Pharmaceuticals, Nicholas Piramal and Cadila Healthcare are the likely beneficiaries.
- On the export front, the growth is expected to be strong, on the back of new product launches, especially of products under 180-day exclusivity. For example, Ranbaxy Laboratories is expected to derive strong sales from "Zocor" under 180-day exclusivity while Dr Reddy's Laboratories may witness revenue upsides from the sale of "Zocor" and "Proscar" under authorised generic terms with Merck Inc. Similarly, Cipla is expected to strengthen its exports by supplying active pharmaceutical ingredients (APIs) of "Zoloft" and "Proscar" to Teva.
- With a greater number of players entering the generic space in the USA, pricing pressures are likely to continue. The pricing environment in the key markets of Europe too is likely to be tough with the ongoing regulatory reforms.
- The merger and acquisition (M&A) focus of Indian pharmaceutical companies has continued in the quarter, with Ranbaxy Laboratories acquiring South African Be Tabs and Wockhardt acquiring the Irish generic company, Pinewood. The integration of past acquisitions is likely to get reflected in the earnings growth of the pharmaceutical companies during the quarter. Moreover, we expect the Indian pharmaceutical companies to continue to widen their geographical presence and expand product portfolios through inorganic means.
- On the domestic front, the contentious issues of pricing control, data exclusivity etc continue to loom over the domestic pharmaceutical industry. Despite this, the increasing focus on the high-margin regulated markets coupled with an improvement in the product mix (moving more towards the high-margin formulation business), improved cost discipline and shifting of

Quarterly estimates: September-December 2006

Company	Net sales			Operating margin (%)		Net profit		
	Sep-Dec 06	Sep-Dec 05	% yoy growth	Sep-Dec 06	Change (bps)	Sep-Dec 06	Sep-Dec 05	% yoy growth
Ranbaxy Labs	1637.3	1387.7	18.0	17.4	1280	174.1	68.6	153.7
Cipla	952.7	780.6	22.0	24.8	440	192.1	102.6	87.3
Sun Pharma	536.1	424.7	26.2	34.0	150	180.7	146.4	23.4
Wockhardt	487.7	365.9	33.3	21.0	-220	77.7	73.0	6.4
Lupin	491.9	426.9	15.2	15.4	190	56.1	44.2	26.9
Nicholas Piramal	593.8	402.6	47.5	15.0	320	56.3	9.7	481.5
Orchid Chemicals	246.7	237.6	3.8	31.5	230	28.1	29.0	-2.9
Cadila Healthcare	436.9	369.5	18.2	20.1	250	53.0	39.6	33.8
Elder Pharmaceuticals	116.4	87.8	32.5	18.5	-100	14.4	10.7	34.5
Total	**5499.4**	**4483.4**	**22.7**	**21.1**	**540**	**832.5**	**523.8**	**58.9**

production to tax-free zones is likely to get reflected in the improving operating profit margin (OPM) of the Indian pharmaceutical companies. We expect the OPM of the pharmaceutical companies under our coverage to expand by 540 basis points in Q3FY2007.

- The recent outlicencing deal of Glenmark Pharmaceutical's anti-diabetic molecule to Merck KG has reinforced confidence in India's innovative and research abilities. India's capabilities in drug discovery research are being increasingly recognised by global pharmaceutical majors. Lupin's anti-migraine compound entering Phase III clinical trials further vindicates the capabilities of the Indian companies to create their own innovative new chemical entity (NCE) pipeline. We expect further positive news flow on the innovative research and development (R&D) front from Sun Pharmaceuticals, Lupin, Dr Reddy's Laboratories and Glenmark Pharma in the coming quarters.
- The strong cost control initiatives coupled with the synergies derived out of the integration of acquisitions are expected to drive the earnings growth of the Indian pharmaceutical companies. The pharmaceutical companies under our coverage are expected to report a jump of 58.9% in their net profit in Q3FY2007.

Ranbaxy Laboratories

Ranbaxy Laboratories is expected to report an 18% hike in its net sales to Rs1,637 crore for Q3FY2007, driven largely by the incremental revenues flowing from "Zocor" (80mg) under the exclusivity terms and the integration of the Terapia acquisition. We estimate the company (supported by the Zocor exclusivity, Loperamide and Simethicon over-the-counter [OTC] tablet exclusivity, and the launch of Cefprozil in the USA) would generate US$114.8 million from North America during the quarter. Further, the strong growth in Terapia (which grew by 49% in Q3CY2006), entry into the Japanese market and aggressive new launches (either from its own base or from the in-licenced base) in both the domestic and the international market will support the revenue hike during the quarter. With the high-margin revenues flowing from product exclusivities in the USA and enhanced focus on cost-cutting efforts, Ranbaxy Laboratories is likely to witness a 1,280-basis-point expansion in its OPM to 17.4%, leading to an impressive 154% jump in its net profit to Rs174.1 crore.

Cipla

We expect Cipla to deliver a 22% growth in the top line in Q3FY2007, driven by a strong growth in both the domestic and the international markets. Particularly, the domestic revenue is likely to show a 20% improvement. On the other hand, with its strong presence in 160 countries, broad-based US partnerships and API supplies for Setraline and Finasteride to Teva, Cipla is expected to show a 21% rise in its export revenue. Amidst the increasing share of the high-margin export revenues and the improving product mix, we believe, Cipla's OPM will expand by 440 basis points to 24.8% during Q3FY2007. We expect Cipla's bottom line to grow by 87.3% to Rs192.1 crore in Q3FY2007.

Sun Pharmaceuticals

Sun Pharmaceuticals is likely to report a 26.2% revenue growth on the back of a 16% sustained improvement in its domestic business (industry grew by 17-18%) and an impressive 40% jump in its exports in Q3FY2007. Despite pricing concerns, Caraco (the US outfit of the company) is expected to maintain its momentum primarily supported by new product launches (like Glipizide, Baclofen, Gabapentin and Phenytoin) and progressive enhancement in its share in the US market. We estimate Caraco to generate revenue worth $28 million in the quarter. This coupled with the improving performance in the semi-regulated markets would boost the formulation exports by 42%. With the vertical integration in some of its products and increasing revenues flowing in from the regulated markets, the OPM is likely to expand by 150 basis points, leading to an impressive growth of over 23.4% in net profit to Rs18.7 crore in Q3FY2007.

Wockhardt

Wockhardt is expected to show a strong growth of 33.3% in its sales, driven by a full quarter impact of the recently acquired Pinewood, steady contributions from the Dumex business, ramp-up in its US business after the restructuring of its sales distribution system, the newly launched Cefotaxime injections and the steady growth in its UK business. However, the uptrend in the raw material costs is expected to hit the OPM, which is expected to decline by 220 basis points year on year (yoy). Moreover, an increase in depreciation (due to the commissioning of the new biotech facility at Aurangabad) along with the higher tax rate (due to an increase in the minimum alternative tax) will cause Wockhardt's net profit to grow by only 6.4% to Rs77.7 crore.

Nicholas Piramal

Nichols Piramal is anticipated to deliver over 47% top line growth to Rs593.8 crore, driven mainly by the full impact of the acquisition of Pfizer's manufacturing facility at Morpeth, UK and the increased momentum in the CRAMS business. Also the strong revival of its largest brand, Phensedyl, is likely to fuel the revenue growth in Q3FY2007. (Phensedyl sales were hit by the unfortunate controversy caused by the Narcotic Control Bureau in the corresponding quarter of the previous year). Despite margin pressure from the integration of the loss-making Avecia, Nicholas Piramal (supported by the increasing CRAMS revenue, improved product mix and progressive shifting of manufacturing to excise-exempt facility) would expand its OPM by 320 basis points to 15%. With the rising top line and expanding OPM, we expect Nicholas Piramal to deliver a whopping 481.5% jump in its net profit to Rs56.3 crore in Q3FY2007.

Lupin

We expect Lupin's sales to grow by 15.2% yoy to Rs491.9 crore in Q3FY007, driven by a stronger than industry growth in its domestic revenues and a pick-up in its US sales. Lupin's API sales to the regulated markets are likely to increase marginally as compared to the previous quarter as the company increases supplies of Ceftriaxone. (Ceftriaxone supplies were hit in the last quarter due to capacity constraints). However, formulation revenues from the USA are likely to show a robust pick-up on account of the full quarter's impact of the recently launched Ceftriaxone 10mg vials and the Lisinopril-HCTZ tablets. We expect the sales of Lupin's branded formulation, Suprax, to remain moderate as the flu season has not yet completely set in, in the USA. A 190-basis-point improvement in the OPM coupled with a substantially higher other income is expected to drive Lupin's net profit up by 26.9% to Rs56.1 crore in the quarter.

Cadila Healthcare

An improvement in the domestic formulation business post-restructuring, a strong growth in the consumer products business and steady contributions from the export markets are likely to drive up Cadila Healthcare's revenues by 18.2% in Q3FY2007. On the export front, we expect the growth to be driven largely by the growing revenues from the French and US businesses. Revenues from the company's joint venture with Altana are expected to reduce in H2FY2007 as the company has already booked a large part of the same in H1FY2007. Continued focus on cost-cutting initiatives is likely to result in a 250-basis-point improvement in the company's margins yoy. However, on a sequential basis, we expect the company's margins to decline by 280 basis points as the volumes in the high-margin Altana business come down. Cadila Healthcare has also commenced supplies of Simvastatin to the US markets, following the expiry of the 180-day exclusivity on December 23, 2006. However, we do not expect any significant upside from this launch in Q3FY2007 due to the intense competition with eight players entering the market on Day 1 following patent expiry. We expect the company to report a 33.8% rise in its net profit to Rs53.0 crore in Q3FY2007.

Orchid Chemicals

We expect Orchid Chemicals' revenues to grow by a meagre 3.8% in Q3FY2007, as the company has had no major launches in the US market during the quarter. The US market is the main growth driver for the company. The only new launch it has had in Q3FY2007 is of the Cefadroxyl tablet, which is only a $36-million product. With the flu season not completely setting in as yet in the USA, even the growth coming from the existing antibiotics is likely to be minimal. An improving product mix, with a higher share of formulations, is expected to improve the OPM by 240 basis points yoy to 31.5%. However, Orchid Chemicals' net profit growth on a year-on-year basis is likely to be affected by the high base effect of Q3FY2006, in which quarter the profits were high due to a lower depreciation charge and substantially lower tax provisioning. Due to this, we believe that the company's net profit in Q3FY2007 will decline by 2.9% yoy to Rs28.1 crore.

Elder Pharmaceuticals

Elder Pharmaceuticals is expected to show a strong growth of 32.5% yoy in its revenues, led by the continued growth momentum in its key brands, such as Shelcal, Chymoral and Eldervit, growing sales of the Fair One brand and steady revenues from its in-licenced portfolio. We expect the company's OPM to decline by 100 basis points yoy to 18.5% on account of higher selling and marketing expenses. Stable interest and depreciation costs along with a lower tax outgo (as the company continues to derive an increasing proportion of its income from tax-free areas) will cause Elder Pharmaceuticals' net profit to grow by 34.5% yoy to Rs14.4 crore.

Valuation table: Sharekhan pharma universe

Company	CMP	EPS			P/E multiple		
		FY06	FY07E	FY08E	FY06	FY07E	FY08E
Ranbaxy Labs **	417.0	7.0	16.3	20.8	59.3	25.6	20.0
Cipla	244.0	7.8	9.8	12.0	31.2	25.0	20.3
Sun Pharma	986.0	30.9	34.0	45.8	31.9	29.0	21.5
Wockhardt **	343.0	23.5	22.7	30.6	14.6	15.1	11.2
Lupin	578.0	20.7	26.8	37.2	27.9	21.5	15.6
Nicholas Piramal	247.0	6.0	10.7	16.0	41.4	23.0	15.4
Orchid Chemicals	199.0	12.8	13.3	25.5	15.5	15.0	7.8
Cadila Healthcare	355.0	12.1	18.1	23.4	29.3	19.7	15.2
Elder Pharmaceuticals	394.0	21.0	27.1	36.4	18.8	14.5	10.8

** EPS and P/E multiple are for CY06, CY07 and CY08

The author doesn’t hold any investment in any of the companies mentioned in the article.